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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Secretary Of Defense

DOD Guidance On The Combined Procurement Procedure Needs Provisions For Audit Verification

The objective of the Department of Defense's (DOD's) combined procurement procedure is to reduce acquisition costs by consolidating orders for spare parts with orders for production components. GAO concluded that the DOD guidance on the procedure should contain provisions requiring audit verification that manufacturers are combining orders for pricing purposes. DOD agreed with GAO's recommendation on this matter and stated that audit verification provisions would be included in a military standard or another appropriate publication.

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

B-219058

The Honorable Caspar W. Weinberger
The Secretary of Defense

Dear Mr. Secretary:

We have reviewed existing and proposed Department of Defense (DOD) guidance on the use of the combined procurement procedure to order spare parts and production components for weapon systems. Our review showed that audit verification is needed to ensure that manufacturers are combining orders for pricing purposes.

The combined procurement procedure is a technique whereby orders for spare parts are consolidated with orders for production components so that a manufacturer achieves one overall production schedule. Consolidation of orders is a practice industry follows to reduce production costs. Savings are achieved through economies of scale, resulting in lower unit costs. The military services have been using the combined procurement procedure, to varying degrees, for the past several years.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to determine whether DOD guidance on the combined procurement procedure was adequate to ensure that the savings from the procedure were being realized. To determine how well the procedure was being implemented, we reviewed the Navy's F/A-18 aircraft program.

We made our review at the Office of the Assistant Secretary of Defense (Manpower, Installations and Logistics); Naval Aviation Supply Office (ASO); and McDonnell Aircraft Company, the prime contractor for the F/A-18 aircraft. The prime contractor purchases the production components for the aircraft from various manufacturers and ASO does the same for spare parts.

We reviewed existing and proposed DOD guidance on the combined procurement procedure and held discussions with DOD officials responsible for this guidance. With regard to the F/A-18 program, we analyzed Navy and contractor procurement records and purchase files, reviewed DOD and contractor audit reports, and interviewed Navy and contractor officials involved in the ordering, estimating, and negotiating processes.

Our review was made in accordance with generally accepted government auditing standards and was performed between July 1984 and April 1985.

DOD GUIDANCE

DOD Directive 4140.40, "Provisioning of End Items of Materiel," states generally that, under certain conditions, consideration shall be given to ordering spare parts concurrently with production components. Recognizing the need for a more definitive DOD policy regarding the implementation of the combined procurement procedure, DOD has drafted a separate instruction on the procedure.

The proposed instruction (1) makes it mandatory that the combined procurement procedure be considered in acquiring spare parts and production components, (2) expresses a preference for acquiring spare parts directly from subcontractors because of the expectation of prime contractor surcharges, and (3) requires that prime contractors furnish DOD information on the timing of its orders for production components.

However, the instruction does not contain provisions on audit verification. On the basis of our work on the F/A-18 program, we believe that audit verification is needed to ensure that manufacturers are combining orders for spare parts and production components for pricing purposes.

F/A-18 PROCEDURES

Starting in fiscal year 1983, ASO ordered all F/A-18 spare parts directly from the manufacturers and took actions to obtain the benefits of the combined procurement procedure. ASO informed the manufacturers that, where possible, it intended to place the orders for spare parts concurrently with the prime contractor's orders for production components. The manufacturers generally indicated that they were willing to combine the orders. Also, ASO asked the prime contractor for information on the anticipated orders for production components. The prime contractor responded by furnishing a schedule showing the components it planned to buy and the estimated dates (ordering windows) when it intended to issue purchase orders.

These actions were helpful in making the prime contractor and the manufacturers aware that ASO wanted orders combined and coordinated. However, our review of ASO and prime contractor files for 11 of the 18 manufacturers providing production components and spare parts for the F/A-18 aircraft showed that ASO did not have a systematic approach for verifying that the manufacturers actually were combining orders for pricing purposes.

For example, in response to a 1983 order primarily for 28 gas power units to be used as spare parts, the manufacturer initially quoted a price of $3.3 million and advised ASO that a cost avoidance of $9,650 was achieved by combining the order for spare parts with an order from the prime contractor for production components.

ASO questioned the reported savings because it was extremely low and requested proof that the two orders had been combined for pricing purposes. In response, the manufacturer changed its position and stated that the initial price quotation was not based on combined orders. However, the manufacturer subsequently submitted a revised quotation of $2.9 million for the spare parts. ASO was uncertain whether the revised price was due to combined ordering.

One procedure to assure that orders are combined when appropriate would be to furnish the Defense Contract Audit Agency (the organization that would perform the actual audit verification work) information on the numbers, dates, and quantities of all the orders to be combined with the DOD orders, rather than just information on the DOD order being audited.

CONCLUSIONS AND RECOMMENDATIONS

We believe that the benefits of the combined procurement procedure would be enhanced if audit verification requirements were added to the proposed DOD instruction or to other guidance on the procedure. In this way, DOD would have assurances that it is sharing in the economies of scale savings the manufacturers realized. We envision that the Defense Contract Audit Agency would verify that orders are combined as part of its normal auditing procedures. To assist the audit agency, DOD procurement offices would have to furnish it information on the prime contractor orders to be combined with the DOD orders, not just information on the order being audited.

In view of the above, we recommend that you add provisions to the proposed DOD instruction or to other guidance on the combined procurement procedure that would require that whenever the Defense Contract Audit Agency is requested to audit a proposal that it be provided the necessary information to verify that orders are combined for pricing purposes.

Because issuance of the additional DOD guidance could take several months, we believe that more immediate measures should be taken with regard to the F/A-18 aircraft program. Therefore, we recommend that you direct the Secretary of the Navy to ask the Defense Contract Audit Agency, as part of its normal audit work, to verify that the F/A-18 manufacturers are combining orders for pricing purposes.

AGENCY COMMENTS

On June 13, 1985, DOD provided official written comments on a draft of this report. (See app. I.) DOD agreed in principle with both of our recommendations. In our draft report we suggested that the audit verification provisions be added to the proposed DOD instruction. DOD stated that, instead, the provisions would be included in a military standard or in another

appropriate publication. We see no problem with this course of action and have revised the recommendation accordingly. DOD also stated that the Navy had been requested to take action to ensure that the Defense Contract Audit Agency is provided the information necessary to verify that the F/A-18 manufacturers are combining orders for pricing purposes.

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As you know, 31 U.S.C. §720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of the report to the Chairmen of the above committees; the Chairmen, Senate and House Committees on Armed Services; the Secretary of the Navy; and the Director, Office of Management and Budget.

Sincerely yours,

for Frank C. Conahan
Director

APPENDIX I

THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301-4000

SR
MANPOWER, INSTALLATIONS AND LOGISTICS

13 JUN 1985

Mr. Frank C. Conahan
Director
National Security and International
Affairs Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Frank Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "Defense Guidance on the Combined Procurement Procedure Needs Provisions for Audit Verification," dated May 6, 1985 (GAO Code 394020, OSD Case #6746).

The DoD concurs with the recommendations that the Defense Contract Audit Agency (DCAA) be provided the necessary information to verify that orders are combined for pricing purposes, and that DCAA be requested to verify that the F/A-18 manufacturers are combining orders for pricing purposes.

Upon publication of the DoD Instruction on Spares Aquisition Integrated with Production (SAIP), a joint DoD group will be established to develop a Military Standard to be a companion document to the Instruction. The concept of audit verification will be referred to the group for inclusion into the Military Standard, or whichever publication or publications are deemed appropriate.

The Navy has been directed to ensure that the DCAA is provided the information necessary to verify that the F/A-18 manufacturers are combining orders for pricing purposes.

Detailed comments on the findings and recommendations contained in the Report are enclosed. Your efforts in assisting the DoD in improving its use of the SAIP concept are greatly appreciated.

Sincerely,

Lawrence J. Korb
Assistant Secretary of Defense
(Manpower, Installations & Logistics)

Enclosure
As stated

GAO note: Page references have been changed to correspond to pages in the final report.

GAO DRAFT REPORT - DATED MAY 6, 1985
(GAO CODE NO. 394020) - OSD CASE NO. 6746

"DEFENSE GUIDANCE ON THE COMBINED PROCUREMENT PROCEDURE NEEDS PROVISIONS FOR AUDIT VERIFICATION"

DEPARTMENT OF DEFENSE COMMENTS

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FINDINGS

FINDING A: Combined Procurement Procedures Used by DoD On A Limited Basis. GAO found that the Navy and the Air Force have been using the combined procurement procedure on a limited basis for the past several years. GAO also found that Army has not used this procedure. Additionally, GAO found that the Navy's F/A-18 aircraft program is the first weapon system on which the combined procurement procedure is being fully implemented. [See p. 1.] [See GAO note below.]

DoD Position. Nonconcur. The Army has and is using this procedure. GAO officials stated that the basis for the statement that the Army has not used this procedure is the report sent by the Assistant Secretary of Defense (Manpower, Installations & Logistics) to the Chairman of the House Appropriatons Committee on May 1, 1985. The report, however, did not say that the Army had not implemented the procedure. Instead, it said that the Army had no documented instances where the procedure had been applied. (The Army was unable to supply the necessary information in time to meet the Committee's deadline.) Subsequent to submission of the report to the House Appropriations Committee, the Army identified 24 systems on which the procedure had been applied.

Also, the combined procurement procedure has been fully implemented on other weapon systems prior to the F/A-18. One such system is the Air Force F-15. It is believed that GAO may not understand what constitutes full implementation of the procedure. Full implementation does not necessarily mean that all spare parts will be purchased under the combined procedure, but that they will be purchased under the procedure when it is economical to do so.

FINDING B: DoD Combined Procurement Policy Guidance Is Being Amplified. GAO found that DoD has recognized the need for more definitive policy than that contained in DoD Directive 4140.40, "Provisioning Of End Items Of Materiel," which merely states that consideration shall be given to ordering spare parts concurrently with production components. The DoD, therefore, GAO further found, has drafted a separate instruction on the combined procurement procedure which requires:

GAO note: Our final report was modified to reflect DOD's comments on this matter.

(1) Mandatory consideration of the procedure,

(2) that, preferably, spares be acquired directly from the subcontractor, and

(3) prime contractors to furnish information on the timing of production component orders.

However, GAO additionally found, the instruction does not contain provisions for audit verification. GAO concluded that the benefits of the combined procurement procedure would be enhanced if audit verification were added to the proposed DoD Instruction. [See pp. 2 and 3.]

DoD Position. Concur in principle. The section titled "Contracting and Negotiating" that was in the draft instruction provided to GAO will not appear in the final instruction. Instead, requirements to be levied upon contractors when SAIP is applied will be published in a DoD Military Standard. Immediately upon publication of a SAIP instruction, (estimated publication date August 1985) a joint DoD group will be established to develop the Military Standard. This GAO recommendation will be referred to the group for inclusion into the Military Standard, or whichever publication or publications are deemed appropriate.

FINDING C: F/A-18 Program Shows Audit Verification Of Combined Procurement Procedure Is Necessary. GAO found that starting in FY 1983, the Navy's Aviation Supply Office (ASO) ordered all F/A-18 spare parts directly from the manufacturers and took actions to obtain the benefits of the combined procurement procedure. GAO also found (in reviewing prime contractor files for 11 of 18 spares manufacturers) however, that ASO did not have a systematic approach for verifying that the manufacturers actually were combining orders. To assure that orders are combined where appropriate, GAO concluded that the Defense Contract Audit Agency (DCAA), as part of the normal auditing procedures, would verify that orders are combined. To assist the DCAA audit, GAO further concluded that DoD procurement offices will have to furnish the necessary information on the prime contractor orders to be combined with the DoD orders. Further, because issuance of the DoD instruction could take several months, GAO additionally concluded that more immediate measures should be taken with specific regard to the F/A-18. One procedure, according to GAO, could be to furnish the DCAA information for audit verification on the numbers, dates, and quantities of all the orders to be combined with the DoD orders, not just information on the order being audited. [See pp. 2 and 3.]

DoD Position: Concur.

RECOMMENDATIONS

RECOMMENDATION 1: GAO recommended that the Secretary of Defense add provisions to the proposed DoD instruction on the combined procurement procedure which would require that whenever the Defense Contract Audit Agency is requested to audit a proposal that it be provided the necessary information to verify that orders are combined for pricing purposes. [See p. 3.]

DoD Position: Concur in principle. The section titled "Contracting and Negotiating" that was in the draft instruction provided to GAO will not appear in the final instruction. Instead, requirements to be levied upon contractors when SAIP is applied will be published in a DoD Military Standard. Immediately upon publication of a SAIP instruction, (estimated publication date August 1985) a joint DoD group will be established to develop the Military Standard. This GAO recommendation will be referred to the group for inclusion into the Military Standard, or whichever publication or publications are deemed appropriate.

RECOMMENDATION 2: GAO recommended that the Secretary of the Navy ask the Defense Contract Audit Agency, as part of its normal audit work, to verify that the F/A-18 manufacturers are combining orders for pricing purposes. [See p. 3.]

DoD Position: Concur. The Navy has been requested to take appropriate action to assure DCAA performs this verification.

(394020)